

Central Intelligence Agency



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## DIRECTORATE OF INTELLIGENCE

## China: Recent Economic Reforms

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Summary

China's ambitious economic reform program has gained momentum since April of last year, with reformers--backed by Deng Xiaoping--pushing through major policy directives regarding agriculture and industry. The new policies are not capitalist, but they do represent a pronounced break with traditional Marxist economic practices and, thus, are controversial. Beijing's recent crackdown on economic crimes such as price gouging, speculation, blackmarketeering, and cadre abuse of power, is designed to smooth the way for wage and price reforms that will be implemented later this year.

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Industry

The Third Plenum of the 12th Party Congress in October 1984 placed the party's official stamp of approval on many industrial reform measures that Beijing has experimented with since 1979. The most important industrial reforms approved at the plenum are:

- Reform of the Planning System. China is gradually moving away from the rigid central planning system modelled on the Soviet Union. Under the reforms, production of items of national importance--such as steel, petroleum products and chemicals--remain under mandatory state quotas. Most products, however, are to be produced under "guidance plans" that are set by the state but that are flexible
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This memorandum was prepared by [redacted] China Division, Office of East Asian Analysis. It was requested by Department of Commerce. Comments and questions are welcome and should be directed to Chief, Domestic Policy Branch [redacted]

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enough to enable enterprises to adjust to changing market conditions. Some consumer items and over-quota production of most goods are to be regulated by China's equivalent of an open market.

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-- Enterprise Autonomy. A major goal of the reforms is to increase the authority of enterprise managers and reduce the power of party and government officials in economic decisionmaking. Managers already have more leeway to develop production and marketing strategies, hire and fire workers, and set prices and wages; the control of central ministries and provincial governments is to be reduced correspondingly. Competition between enterprises is encouraged.

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-- Price Reform. In perhaps the most important measure, Beijing has begun to adjust domestic prices and reform the pricing mechanism. Prices of key products such as coal and steel will still be set by the state but at levels that better reflect relative scarcities in the economy. The prices of many other products, including most manufactures, will fluctuate in response to market conditions within bounds set by the state. Supply and demand alone now determine the prices of minor consumer goods such as some clothing products, cosmetics, and vegetables.

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-- Wage Reform. Wages, once guaranteed regardless of output or qualifications, will now reflect job performance. Workers with greater productivity will receive higher wages. Wages will also reflect seniority, the cost of living, and skills in great demand.

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-- Tax System. Instead of turning all profits over to the government, enterprises pay a share of their profits in taxes. Enterprise managers can use after-tax profits for worker bonuses or investment.

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-- Bank Reform. The banking system is being reorganized. Bank loans are increasingly replacing government grants as the source of capital for enterprises. Banks now have increased authority to approve or deny loans, and some banks may adjust loan rates within a 20-percent range of the state-set rates.

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-- International Trade. International trade and foreign investment in China is being strongly encouraged. City and provincial governments have more authority to deal with foreign firms. Foreign trade enterprises can now operate as commissioned agents for manufacturers and importers of most products. Some of China's key state

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 enterprises are allowed to engage directly in discussions with foreign businessmen and have independent authority to sign contracts for technological transformation projects, joint ventures, and compensation trade operations. Foreign firms engaged in joint venture production can sell their output within China as long as the venture's foreign exchange expenditures and receipts are balanced.

The industrial reforms approved in 1984 are designed to correct continuing problems in the urban economic sector:

- Inefficiency, waste, and quality problems that persist despite double-digit growth in both 1983 and 1984.
- Commercial and transportation systems that are incapable of handling agricultural surpluses and record production of coal and other raw materials.
- Party and State bureaucracies that continue to meddle extensively in day-to-day business activity, stifling enterprise initiative and productivity.
- Increased subsidies to urban households that have contributed to six consecutive budget deficits totalling \$28 billion.

### Agriculture

In its first major policy statement of 1985, Beijing signalled its intention to place greater reliance on market forces to guide agricultural production. Instead of purchasing all grain produced--and paying a premium price for over-quota production--the state will sign production contracts with individual farmers for a specified quantity of grain. Both the contracted amount of grain and the purchase price will be less than previous averages. Peasants will be encouraged to sell surplus production on the open market, but the state will purchase excess grain if the free market price falls below a state-determined minimum price. Peasants growing grain on land ill-suited to grain production will be offered subsidies to raise livestock or grow cash crops. In addition, price controls on pork and vegetables are being lifted.

The new policies are designed to promote the development of a diversified agricultural sector and to encourage peasants to produce better quality products and make more efficient use of their land. Beijing also wants to reduce the growing surplus of grain caused by earlier agricultural reforms and to relieve the financial burden imposed by the previous commitment to purchase all over-quota production at premium prices.



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Is this Capitalism?

Although a distinct departure from orthodox central planning, the recent reforms will not transform China into a capitalist economy. The state will continue to own the means of production, will still have direct control over output, pricing, and distribution of key products, and will continue to make major investment decisions. The state will also retain the right to appoint or remove enterprise managers and shut down inefficient enterprises. [redacted]

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Problems Accompanying Reform

Although reforms have contributed to rapid economic growth, large increases in personal income and in the money supply and strong industrial demand for raw materials have caused a surge in prices during the past six months. Recently, the Chinese media has suggested a high-level concern with several major problems including inflation, a 1984 budget deficit that was almost twice as large as expected, and a sharp increase in economic crimes such as price gouging, smuggling, and fraud. Beijing anticipated dislocations in the early stages of urban economic reform, but probably has been surprised at the extent to which local officials and enterprise managers have taken advantage of loose reform guidelines to make windfall profits. [redacted]

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The emergence of these problems appears to have intensified debate within the leadership about the direction and pace of economic reforms, and conservative leaders have become more vocal in expressing practical and ideological concerns about the new policies. Reform leaders have responded by tightening supervision of bank credit and worker bonuses and by promising to punish those guilty of economic crimes. The reformers seem determined to press ahead, but we expect them to proceed cautiously, particularly when implementing price reform. [redacted]

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